INSURER FINANCIAL STRENGTH RATING CRITERIA

This is an update to the methodology previously published in January 2021.

There are no material changes and as such no rating impact.

January 2022

I. INTRODUCTION

This report sets out the Criteria for assigning an 'Insurer Financial Strength Rating' (IFSR), which is used by ARC to rate insurance companies. The Criteria are applicable across all insurance sectors, such as Life, Non-Life, Multiline, Captive and Reinsurance, as well as to insurance groups and their operating holding companies.

The IFSR is a rating assigned specifically to insurance companies. It measures the ability of the insurance company to fulfil its insurance claims and policyholders' obligations in the medium-long term, which allows ARC to perform its analysis under a going concern basis.

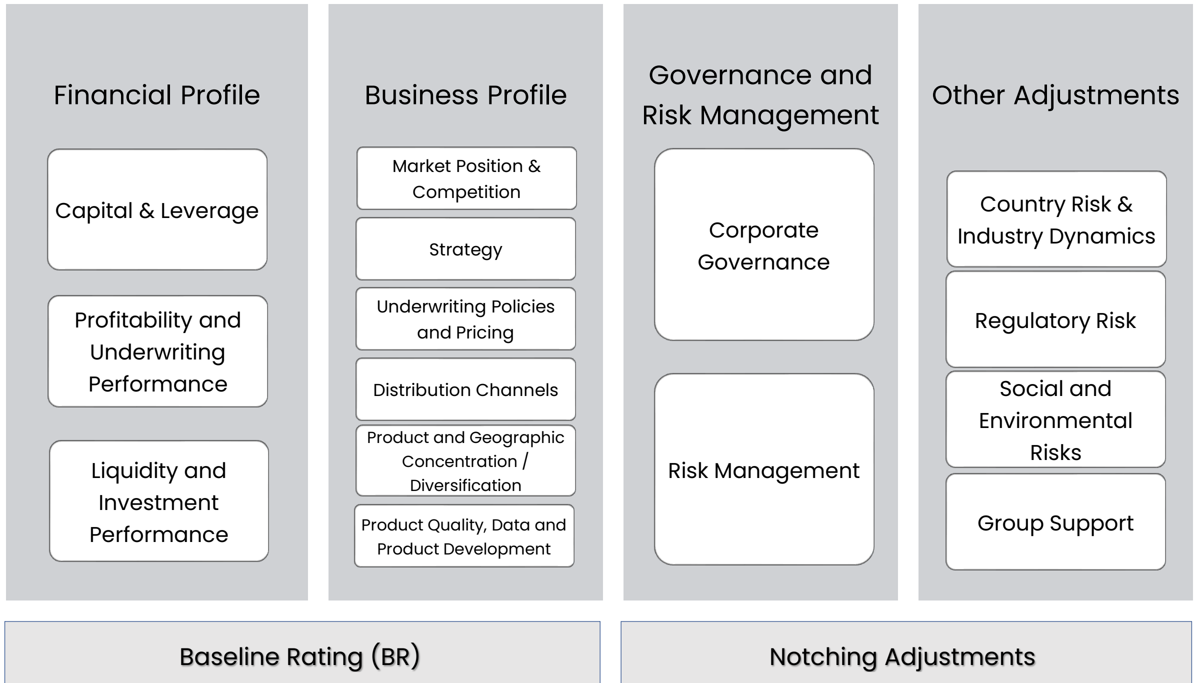
The IFSR typically does not differentiate between local and foreign currency due to the nature of the insurance business that could cover different geographic locations with insurance policies in different currencies (e.g. passporting of services). In particular, cases in which ARC believes it is necessary to specify a currency, the IFSR would be assigned indicating if it refers to local currency or a foreign currency.

The IFSR can be assigned to a separate legal entity, to a group that consolidates different legal entities or to part of a group. The scope of entities covered under an assigned IFSR will be indicated in the rating analysis. The IFSR does not include any assessment regarding the insurer's separated accounts (e.g. unit linked products or any other separated or segregated funds that carry investment risk for the policyholders).

II. INTRODUCTION TO THE IFSR ANALYTICAL FRAMEWORK

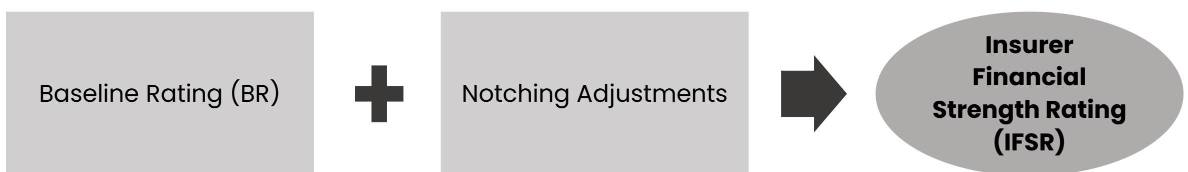
The Criteria are formed by an analytical framework of four pillars, each one considering specific types of analysis and assessments (quantitative and/or qualitative) to identify the strengths and weaknesses of the analysed entity.

ARC's analytical framework for insurance companies:



The first two pillars, Financial Profile and Business Profile, will result in a Baseline Rating (BR). This will assess the balance sheet strength and the business model and performance of the analysed entity in its market. The next two pillars, Governance and Risk Management and Other Adjustments, will potentially result in notching adjustments to the BR, therefore allowing a separation between what is purely performance related (the BR) and other qualitative factors related to governance, risk management, country risk and support among others (the notching adjustments).

The components described in the analytical framework are applied to obtain the IFSR as described in the chart below:



The BR represents ARC's opinion of the stand-alone and individual financial health of an insurance company. This opinion represents the analytical view of the financial strength

based on financial profile fundamentals and business performance. The BR does not under any circumstances represent a credit rating or a default indication of the debt issued by the company. Nevertheless, the BR is helpful for direct comparisons between companies, and is the main driver of the IFSR. The BR is used within all kinds of operating insurance companies. It is not applicable for insurance holdings that do not have active operating units/subsidiaries.

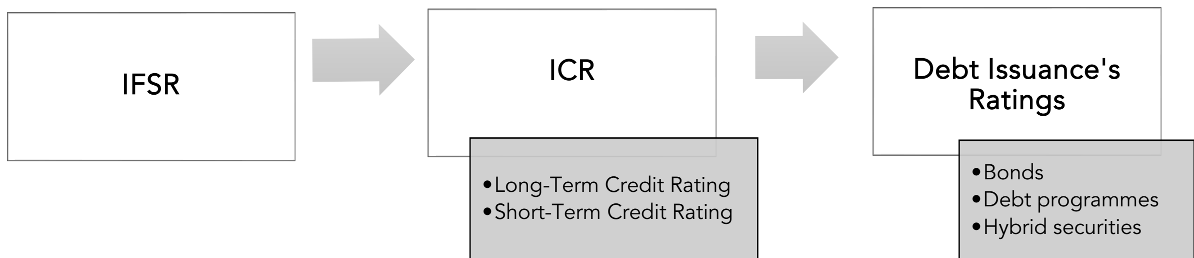
The BR is used as the starting point for the rating analysis then, after applying the other two pillars of the analytical framework, the analysis is completed using notching adjustments if appropriate to obtain the IFSR. In cases where the entity also requires the assignment of an issuer rating or debt rating, those will be based on the IFSR following the structure described in the next section.

When analysing operating insurance companies, ARC usually uses consolidated financial statements. If an entity is part of a financial group, for analytical reasons we assess not only the financial profile of the entity on a stand-alone basis, but also the financial and business profile of the group. We therefore will usually use the group's consolidated financial statements. For operating entities that are highly integrated within a financial group, we could assign an IFSR at consolidated level, and use it as the representation of the credit risk profile of the operating entity for the basis of the IFSR assignation.

III. INSURER FINANCIAL STRENGTH RATING (IFSR) AND ISSUER CREDIT RATING (ICR)

Usually, the IFSR represents the strength of the insurance company in the medium to long-term, however, in cases in which ARC perceives the need of assigning an IFSR for short-term insurance policy obligations (less than 12 months), it will be indicated using the symbols from ARC's short-term credit rating scale.

The IFSR represents the anchor rating that ARC will use to assign any other rating to the insurance entity or group as part of the rating process, including issuer long-term and short-term credit ratings, as well as ratings to debt obligations (senior, subordinated or hybrid).



The Issuer Credit Rating (ICR) is the comparable rating used by ARC across sectors (financial institutions, insurance companies and corporates). The ICR does not reflect a numerical forecasted default rate, nor does it include any opinion related to market risk or any risk other than credit risk.

For insurance companies, the IFSR is used as a starting point to later assign an ICR. Typically, the ICR will be at the same level as the IFSR, unless ARC observes that the insurance company's ability to meet its policyholders' obligations differs significantly from its ability to meet its financial liabilities to creditors. For example, in cases in which the pool of assets is very limited and barely allows to cover best estimates of policyholders' liabilities, the ability of the insurance company to cover other liabilities is limited, which would be reflected with a ICR that is notched down from the IFSR. This will depend on the availability of balance sheet assets to cover other liabilities, not related to policyholders as well as taking into account the regulatory environment in which the entity operates, that could eventually have special procedures for separation of accounts in case of failure to meet policyholder obligations or to maintain solvency ratios.

The ICR will be assigned to an insurance company whenever it has debt obligations of any type and not just in the form of issued bonds.

IV. DEFINITION AND IFSR'S SCALE

The IFSR uses the scale detailed below; except for the 'AAA' and 'CC/C' ratings, each IFSR can be modified by adding a plus or a minus, indicating a stronger (+) or weaker (-) rating within each category.

Rating	Definition
AAA	**'AAA'** denotes the highest rated insurance companies, with excellent indicators in all the factors that compose the IFSR. It represents companies with solid financial profiles and successful business models supported by an excellent risk management framework. An excellent capital base to support organic growth and to face expected and any unexpected underwriting risks is also available. Companies are typically located in stable economic environments with highly efficient and predictable regulatory frameworks.
AA	'**AA**' denotes very strong insurance companies, with a combination of excellent and sound indicators within the factors that compose the IFSR. It represents insurance companies with solid financial profiles and recognised business models supported by a very strong underwriting risk framework. A very strong capital base to support organic growth and to face expected and unexpected underwriting risks is available. Companies in this category are typically located in stable economic environments with highly efficient and predictable legal and regulatory frameworks.
A	'**A**' denotes strong insurance companies with a mixed combination of good indicators within the factors that compose the IFSR. It represents companies with stable financial profiles and recognized business models supported by good underwriting risk frameworks. A strong capital base to support organic growth is available with a comfortable base to face expected and unexpected underwriting risk. Companies are typically located in stable economic environments with efficient and fairly predictable legal and regulatory frameworks.
BBB	'**BBB**' denotes satisfactory insurance companies with a combination of satisfactory performance indicators within the factors that compose the IFSR. It represents companies with adequate financial profiles and stable business models (sometimes also niche players) supported by an adequate, but still requiring improvement, management of underwriting risk. An adequate capital base to support organic growth is available; strengthening of capital ratios and reserves is expected. Companies are typically located in economic environments with some level of stability, however some deficiencies in the level of development of the legal and regulatory environment exist.
BB	'**BB**' denotes moderate insurance companies with a combination of moderate indicators within the factors that compose the IFSR. It represents companies with moderate financial profiles and a business model that faces tough competition. Also, they have underwriting risk models that require improvement. The capital base to support organic growth and to face expected and unexpected underwriting risks is limited and should be strengthened to provide more stability. Companies are typically located in economic environments with deficiencies in the level of development of legal and regulatory frameworks.
B	'**B**' denotes weak insurance companies with a combination of weak performance indicators within the factors that compose the IFSR. It represents companies with weak financial profiles and limited business models that face tough competition and with basic risk management frameworks that require material improvement. The capital base does not support organic growth and does not provide financial stability to face unexpected underwriting risks. Companies are typically located in economic environments with evident deficiencies in the level of development of legal and regulatory aspects and with unpredictable behaviour patterns.
CCC/CC/C	'**CCC/CC/C**' denotes very weak insurance companies, with a combination of poor and very weak indicators within the factors that compose the IFSR. It represents companies with very weak financial profiles, limited business models that face tough competition and with extremely deficient underwriting risk management. The capital base and reserves are weak and should be increased. Companies are typically located in economic environments with evident deficiencies in the level of development of legal and regulatory aspects, and also with extremely unpredictable regulatory behaviour driven by individual objectives.
D	**'D'** denotes defaulted insurance companies, with very weak indicators within the factors that compose the IFSR. Companies would typically be under regulatory intervention or negotiating a creditors' agreement.

ARC assigns a rating outlook (**positive**, **stable**, **negative** or **developing**) together with the IFSR. The rating outlook highlights the potential direction of a rating during the course of an 18 months to 2 years period. An outlook is not necessarily a precursor of a rating change or future review ahead of schedule.

V. IFSR ANALYTICAL FRAMEWORK

The IFSR is the result of four key analytical pillars that ARC believes represent the main drivers that reflect an insurance company's credit profile.

The IFSR is determined based on historic financial data for the purpose of obtaining a 'Historic IFSR', as well as based on assumptions, projections and forecasts defined by the analyst to obtain a 'Forecast IFSR'. The assigned IFSR will be the combination of the Historic and the Forecast. The Historic IFSR is typically derived using annual financial data for the preceding 3 to 5 years together with current year-to-date data (if available and meaningful), which allows to avoid cyclicality that could trigger a biased analytical conclusion. Exceptions could be done, provided that there is a reasonable rationale that justifies its use. The Forecast IFSR is typically obtained over a 2-year time horizon. However, the time horizon could change depending on the nature and characteristics of the entity under analysis.

The four key analytical pillars include both qualitative and quantitative assessments. For ratios and quantitative factors, the analysis is based on internal benchmarks produced by ARC and built using publicly available information and ARC's proprietary information. For qualitative factors, the analysis is done using a specific set of positive or negative assessments, e.g. excellent, strong, neutral, weak or very weak.

Detailed description of the IFSR analytical components (Baseline Rating):

Pillar	Sub-section	Factor	Sub-factor	Type of Analysis
(I) Financial Profile	Capital & Leverage	Capital	Excess Capital	Ratio
			Regulatory Solvency II	Ratio
		Leverage	Financial Leverage	Ratio
			Financial Flexibility	Qualitative
	Profitability and Underwriting Performance	Profitability	RoE	Ratio
			RoA (pretax)	Ratio
		Underwriting Performance	Loss Ratio	Ratio
			Combined Ratio	Ratio
			Technical Profitability	Ratio
		Growth	Assets Growth	Ratio
			Premiums Growth	Ratio
	Liquidity and Investments Performance	Liquidity and Portfolio Analysis	Liquid Assets to Total Investment Portfolio	Ratio
			Liquid Assets to Policyholder Liabilities	Ratio
			Equity Investments to Capital	Ratio
			Real Estate Investments to Capital	Ratio
		Investment Performance		Qualitative
(II) Business Profile	Market Position & Competition	Market Share		Qualitative
		Competitive Position		Qualitative
	Strategy	Strategic Achievements and Future Goals		Qualitative
	Underwriting Policies & Pricing	Pricing Policies		Qualitative
		Underwriting Policies		Qualitative
	Distribution Channels	Diversification of Channels		Qualitative
		Strength of Channels		Qualitative
	Product and Geographic Concentration	Product Concentration		Qualitative
		Geographic Concentration		Qualitative
	Product Quality and Product Development	Product Quality		Qualitative
		Product Development and Innovation		Qualitative

Detailed description of the IFSR analytical components (Notching Adjustments):

Pillar	Sub-section	Factor	Sub-factor	Type of Analysis
(III) Governance and Risk Management	Corporate Governance	Governance		Notching
	Risk Management	Reserving Risk		Notching
		Reinsurance Risk		Notching
		Investment Risk		Notching
		Liquidity Risk		Notching
		Capital Management Risk		Notching
		Operational Risk		Notching
(IV) Other Adjustments	Country Risk & Industry Dynamics	Country Risk		Notching
		Industry Dynamics		Notching
	Regulatory Risk			Notching
	Social and Environmental Risk			Notching
	Group Support			Notching

Each factor and sub-factor will be analysed based on a benchmark (in the case of financial ratios) or based on a qualitative assessment (in the case of notching). For the purpose of understanding the dynamics of the analysis and the effect each pillar has on the Baseline Rating, the assessment of each sub-section will be disclosed as part of the analysis.

Note on Separated Accounts:

For analytical purposes, in the case of Life and Non-Life companies, ARC analysts could adjust balance sheet and income statement accounts to exclude items related to separated accounts. This is done to be able to isolate separated accounts related to 'unit-linked' assets/liabilities and 'reinsurance assets', since those items have risks carried by policyholders/reinsurers and not by the insurance company under analysis. Any adjustments made will be based on the available information and will be disclosed and explained in relation to each account affected.

I FINANCIAL PROFILE

1. Capital & Leverage:

a. Capital:

Capital is fundamental to the financial stability of any insurance company. It is the most certain source of funds to absorb potential and unexpected losses caused by the normal operation of risk underwriting or any unexpected weakening of operational earnings due to reduction in premiums written, increase in operational expenses related to changes in distribution channels or unexpected losses from the investment portfolio.

To maintain a reasonable level of protection to policyholders and creditors, insurance companies are normally required by regulators to keep higher capital levels than those obtained from their internal models, to offset potential operational losses. In that context, the capital analysis also includes an understanding of the minimum regulatory

requirements and its comparability across countries and with their internal model (if applicable).

The following ratios are analysed:

- Excess capital (under mild and adverse stressed scenarios).
- Regulatory solvency II.

b. Leverage:

A prudent management of financial leverage can prevent an insurance company from being exposed excessively to financial difficulties generated by unexpected losses, catastrophe risks, and adverse changes in underwriting. If the financial leverage is significant, the effects of a volatile or weak operational performance could ultimately affect the company's capacity to pay policyholders' claims and its financial debt.

High financial leverage may lead to financial instability. As such, an analysis of financial leverage in the capital structure is conducted at both the operating entity and, if applicable, at the holding company level, in order to determine if both balance sheets are sound and unencumbered.

The following sub-factors/ratios are analysed:

- Financial leverage.
- Financial flexibility, measures the ability to access external funding sources.

2. Profitability and Underwriting Performance:

a. Profitability

The ability of an insurance company to generate and maintain strong, sustainable and stable operating earnings is essential for business continuity and long-term solvency. A detailed analysis of profitability, including key performing products, is undertaken to identify the stability and predictability of earnings. Core earnings are identified and analysed depending on the business model. A business model that lacks stable core earnings is more exposed to product demand volatilities and therefore, compares poorly with peers that generate more stable earnings with well positioned products.

A deviation from the defined business model to obtain 'one-off' earnings (e.g. earnings contribution from sales of investments following market opportunities, accounting changes in treatment of investments or unjustified actuarial changes) is not considered positive and thus, is treated as extraordinary earning or non-core profit. In fact, on a case-by-case basis ARC Ratings' analysts may adjust net income for extra-ordinary items, adjustment that will be clearly identified and disclosed. In order to evaluate a company's recurring profitability, items that are unusual in nature and infrequent may be deducted from net income.

The following ratios are analysed:

- RoE.
- RoA (pretax).

b. Underwriting Performance:

Analysis of underwriting performance allows an assessment of how underwriting policies, risk acceptance, pricing and reinsurance policies affect overall product risk and the ability to manage catastrophic events in the long-term. Allows also to evaluate how the company is able to change pricing through the cycle in order to improve technical performance.

The following ratios are analysed:

- Loss ratio (Not applicable for Life Insurance).
- Combined ratio (Not applicable for Life Insurance).
- Technical profitability.

c. Growth

ARC Ratings believes that small insurance companies (in terms of asset size or gross premiums) can enjoy a significant competitive advantage when they build defendable market positions in niche segments through specific market knowledge, and also in terms of underwriting risks as well as pricing.

However, small or modest size is considered to be an adverse factor when it is not supported by a proven market specialisation in niche segments or business lines (e.g. P&C focused on catastrophic risks, agriculture insurance etc.). Small companies with no market specialisation tend to be more concentrated geographically and also less diversified in terms of product, supplier and customer base; thus, more likely to be exposed to adverse financial performance if unexpected catastrophic events occur or health risks arise. Thus, ARC does not consider absolute size as the main measure but uses growth indicators.

The following ratios are analysed:

- Assets growth.
- Premiums growth.

3. Liquidity and Investments' Performance:

a. Liquidity and Portfolio Analysis

Liquidity measures an insurer's ability to meet anticipated short- and long-term obligations to policyholders and other creditors. Liquidity depends on the degree to which financial and policyholder obligations can be satisfied, whether by holding cash and

investments that are sound, diversified, and liquid, or through operating cash flow. A high degree of liquidity helps an insurer meet unexpected cash needs without the need for the untimely sale of investments or fixed assets, which could result in substantial realized losses due to temporary market conditions and/or tax consequences.

The investment portfolio and its liquidity are evaluated and analysed to identify the overall risk and assets' default history to assess the company's absorption capacity without affecting substantially its policyholders' commitments and other debt obligations. A broader diversification in terms of asset classes, geography and maturity, with high asset quality and high liquidity will mitigate any uncertainty in terms of reserves sufficiency to absorb losses if forced asset sales are needed to back policyholders' obligations. Hence, ARC Ratings is keen to understand the company's investment strategy and guidelines and how these are applied to support the company's operating cash flow needs and strategy.

ARC analyses in detail the largest investment exposures or single investments that exceed a material portion of the total capital. In that case, in addition to a qualitative judgment on investment strategy, ARC monitors and evaluates (if possible) the reinvestment rate and any other relevant yield indicators, to understand the rationale and application of the investment strategy and their long-term effects on policyholders' liabilities and other debt obligations. For the purpose of 'liquid assets' definition, ARC usually considers 'cash and cash equivalents' as well as 'AAA' investment securities as the main components.

The following ratios are analysed:

- Liquid assets to total investment portfolio.
- Liquid assets to policyholder liabilities.
- Equity investments to capital.
- Real estate investments to capital.

b. Investment Performance

The assessment of a company's investment performance is important since in the cases in which the technical result from insurance operations is weak, a positive result from the investment portfolio can mitigate the poor technical performance. For Non-Life insurance companies with combined ratios near 100% (combined ratio measured as loss ratio plus expense ratio), the core of the non-insurance profits comes from the return on the investment portfolio and therefore it is key to have and maintain an adequate investment strategy that generates profits in the long-term.

The assessment of investment performance is determined following the definitions described as follows:

Investment Performance Assessment - Definitions
Excellent: Excellent investment performance, track record of investment return consistently above market average.
Strong: Strong investment performance with track record of investment return above market average.
Neutral: Positive track record of investment return, mostly aligned with market average.
Weak: Negative track record of investment return, below market average.
Very Weak: Negative track record of investment return, consistently below market average.

II BUSINESS PROFILE

1. Market Position and Competition

a. Market Share

Small insurance companies (in terms of market share) can enjoy a significant competitive advantage when they build defendable market positions in niche segments through specific market knowledge, in terms of underwriting risks and pricing. However, small or modest size market share is considered to be an adverse factor when it is not supported by a proven specialisation in niche segments or business lines (e.g. P&C focused on catastrophic risks, agriculture insurance, marine insurance etc.). Small companies with no market specialisation tend to be more concentrated geographically and also less diversified in terms of product, supplier and customer base; thus, more likely to be exposed to adverse financial performance if unexpected catastrophic events occur or health risks arise.

The assessment of market share is determined following the definitions described as follows:

Market Share Assessment - Definitions
Excellent: Excellent market position and leading market share per market and product; excellent client recognition and brand name; excellent niche market position.
Strong: Strong market position and leading market share in almost all markets and products.
Neutral: Satisfactory market position and among the top five leaders in market share per market and product.
Weak: Weak market position and weak market share per market and product.
Very Weak: Very weak market position and very weak market share per market and product.

b. Competitive position

The ability of an insurance company to develop a competitive advantage provides a basis to generate stable profits and long-term returns. In that context, an insurance company should carefully manage and monitor the competitive environment to foresee the effects that any competitive change would have on its business model and eventually, competitive position.

Since the insurance industry is very sensitive to changes in pricing and underwriting policies that respond to shifts in risk appetite, the ability of a company to compete and offer differentiated products with adequate risk pricing without jeopardising short-term profitability is carefully analysed. Competitive advantages can be the result of an internal strength or an external factor that allows the insurance company to offer a distinctive product and thus achieve success, often in a niche market. Therefore, insurance companies develop competitive advantages through mastering and exploiting specific knowledge of certain market segments or focusing on business lines where they are able to maintain above-average underwriting performance.

A strong competitive position can also be the result of higher control over distribution channels, appropriate agreements with insurance intermediaries (brokers), efficient underwriting cost structure and easy access to target or captive markets. These strengths are key for an insurance company to be able to consolidate its competitive position. Market dominance in terms of market share is important, however, it is analysed not only in gross terms but also in detail by market, product, underwriting ability, loss-rate track record and ability to absorb unexpected risks or actuarial changes.

The assessment of competitive position is determined following the definitions described as follows:

Competitive Position Assessment - Definitions
Excellent: Excellent client recognition and brand name; excellent niche market position. Strong: Strong client recognition and brand name; strong niche market position. Neutral: Satisfactory client recognition and brand name; satisfactory niche market position. Weak: Weak client recognition and brand name; weak niche market position. Very Weak: Very weak client recognition and brand name; very weak niche market position.

2. Strategy

The assessment of the strategy of any insurance company ranges from a basic review of the organisational structure, to a more in-depth analysis of the managements' skills and

competitiveness to fulfil the strategic plan and, focus on the long-term sustainability of the business model without jeopardising the financial profile.

In any business model, the business philosophy and strategy play key roles in determining the long-term objectives and risks that the management is willing to undertake to achieve its strategic goals. It is important that the management's philosophy and actions provide realistic strategies that reflect the real competitive advantages and disadvantages of the company. Unrealistic growth strategies, relaxing underwriting standards, aggressive pricing strategies, and increasing commissions to intermediaries to gain market share all unnecessarily increase the company's overall risk appetite and misalign the real performance from long-term policies. On the other hand, an overly conservative management strategy may result in missed business opportunities and reduced competitive advantages in the long-term. A comprehensive analysis of the management's ability to implement the business strategy and its competency in achieving the strategic goals is fundamental to the analysis. As a key tool to analyse the implementation of the strategy, ARC requests access to a company's management reporting system and reports to evaluate the soundness of the information and data available for decision-making purposes and consequently to assess the correct execution.

The analysis of the development strategy also includes an analysis of any merger and acquisition (M&A) process in place. It is known that M&A involve risks that are sometimes difficult to identify and quantify. The success and value created through M&A depends heavily on an adequate strategic fit among the merging companies.

Management's business decisions and plans for poorly performing business units or those that no longer make strategic sense represent another relevant area for analysis. Objective appraisals of business units and disciplined approaches in dealing with under-performers (divestiture, restructuring, discontinuation etc.) are also reviewed.

The assessment of strategic achievements and future goals is determined following the definitions described as follows:

Strategic Achievements and Future Goals Assessment - Definitions
Excellent: Thoroughly defined business strategy and goals, fully aligned with core competencies and market developments; excellent track-record of exceeding strategic goals and targets; successful and constant organic growth utilising market opportunities and mitigating risks.
Strong: Very well-defined business strategy and goals very closely aligned with core competencies and market developments; very strong track-record of consistently fulfilling strategic goals and targets; successful organic growth utilising market opportunities and mitigating risks.
Neutral: Adequate business strategy and goals aligned with core competencies and market developments; strategic goals and targets mostly met; organic growth strategy aligned to industry averages and balanced in terms of opportunities and risks.
Weak: Business strategy and goals not thoroughly defined, overly ambitious or not aligned with company or market developments; some underperformance against targets in the past; high risk appetite for organic growth and M&A.
Very weak: Poorly defined or unrealistic business strategy and goals not aligned with company or market developments; track-record of consistent underperformance against targets; aggressive organic growth and M&A with significant uncertainties and risks involved.

3. Underwriting Policies and Pricing

a. Pricing Policies

Since the insurance industry is very sensitive to changes in pricing and underwriting policies that respond to a higher risk appetite, the ability of a company to compete and offer differentiated products with adequate pricing without jeopardising the short-term profitability and increasing risks is carefully analysed.

The assessment of pricing policies is determined following the definitions described as follows:

Pricing Polices Assessment - Definitions
Excellent: Excellent ability to price risk through the cycle evidenced with excellent underwriting results and profitability. Strong: Strong ability to price risk through the cycle evidenced with strong underwriting results and profitability. Neutral: Satisfactory ability to price risk through the cycle evidenced with satisfactory underwriting results and profitability. Weak: Weak ability to price risk through the cycle evidenced with weak underwriting results and profitability. Very Weak: Very weak ability to price risk through the cycle evidenced with very weak underwriting results and profitability.

b. Underwriting Policies

Our analysis is based on the company’s risk appetite in terms of underwriting policies and the identification of business incentives to accept risks; in addition, the practical application of risk appetite is an important factor in assessing underwriting strength.

ARC evaluates underwriting policies, risk acceptance, pricing and reinsurance policies to determine the level of overall product risk and the ability to manage catastrophic events in the long-term. The analysis of reinsurance policies also includes a view of the reinsurance record from past responses and current disputes that can affect the ability of an insurance company to transfer risks and eventually to cover obligations to policyholders. Depending on the risk appetite of an insurance company, the policies and level of reinsurance are tools to spread risk concentration and protect against any risks the company is unwilling to manage and accept.

The assessment of underwriting policies is determined following the definitions described as follows:

Underwriting Polices Assessment - Definitions
Excellent: Excellent underwriting expertise and capacity with excellent underwriting results and profitability. Strong: Very strong underwriting expertise and capacity, with very strong underwriting results and profitability. Neutral: Satisfactory underwriting expertise and capacity, with satisfactory underwriting results and profitability. Weak: Weak underwriting expertise and capacity, with weak underwriting results and profitability. Very Weak: Very weak underwriting expertise and capacity, with very weak underwriting results and profitability.

4. Distribution Channels

a. Diversification of Channels

A strong competitive position can also be the result of higher diversification of distribution channels, adequate agreements with insurance intermediaries (brokers), efficient underwriting cost structure and easy access to target or captive markets. These strengths are key for an insurance company to consolidate its competitive position.

The assessment of diversification of channels is determined following the definitions described as follows:

Diversification of Channels Assessment - Definitions
Excellent: Very large number of distribution channels, excellent productivity and excellent dominance to keep control over any distribution channel. Strong: Large number of distribution channels, strong productivity and strong dominance to keep control over any distribution channel. Neutral: Satisfactory number of distribution channels, satisfactory productivity and satisfactory dominance to keep control over any distribution channel. Weak: Limited number of distribution channels, weak productivity and marginal dominance to control any distribution channel. Very Weak: Very limited number of distribution channels, very weak productivity and very weak dominance to control any distribution channel.

b. Strength of Distribution Channels

Control over and stability of distribution are other relevant factors, as they can ensure effective sales practices. Concentration in a distribution channel is also reviewed, as insurers need to weigh the risk of losing a top channel when choosing to use sales representatives over an automated distribution channel. These are only some of the issues that may arise; rating analysts will consider the implications of an insurer's distribution strategy.

The assessment of strength of channels is determined following the definitions described as follows:

Strength of Channels Assessment - Definitions
Excellent: Demonstrates excellent dominance, productivity and ability to keep control over any distribution channel. Strong: Demonstrates strong dominance, productivity and ability to keep control over any distribution channel. Neutral: Demonstrates satisfactory dominance, productivity and ability to keep control over any distribution channel. Weak: Demonstrates weak dominance, productivity and ability to keep control over any distribution channel. Very Weak: Demonstrates very weak dominance, productivity and ability to keep control over any distribution channel.

5. Product and Geographic Concentration

Product and geographic concentration are important factors in the analysis of any insurance company. In the case of both Life and Non-Life companies, geographic and product concentration can increase underwriting risks and amplify the exposure of the balance sheet to unexpected losses as a consequence of specific events (natural disasters, country economic recession, actuarial changes in annuities, etc.). Therefore, adequate diversification can help insurance companies to develop a more resilient business model with reduced dependence on premiums generated by fewer business lines, target segments or any other risk concentration.

a. Product Concentration

Developing business segments that are not of the company's core expertise, or that are in markets where broader knowledge of risk occurrence or large business intelligence is required to be successful, could be viewed as a potential weakness instead of a business opportunity. In that context, insurance companies that claim to enter a market or to develop a business line only for diversification purposes with no previous expertise in that field, are carefully analysed to determine if the diversification would add strategic value.

In addition, business lines concentrated in market-sensitive products in terms of regulatory pressures (e.g. healthcare) are also evaluated carefully to identify their diversification benefits if combined with other business lines.

The assessment of product concentration is determined following the definitions described as follows:

Product Concentration Assessment – Definitions
Excellent: Excellent mix of products, no concentration of products in market-sensitive sectors, all adding excellent diversification benefit. Strong: Strong mix of products, no significant concentration of products in market-sensitive sectors, all adding strong diversification benefit. Neutral: Satisfactory mix of products, some evidence of concentration of products in market-sensitive sectors but that does not generate losses, adding a satisfactory level of diversification benefit. Weak: Weak mix of products, evidence of large concentration of products in market-sensitive sectors that does generate losses, adding a weak level of diversification benefit. Very weak: Very weak mix of products, evidence of very large concentration of products in market-sensitive sectors that does generate large losses, not adding diversification benefit.

b. Geographic Concentration

The level of products diversification is also influenced by the degree of risks the company is willing to accept, both in terms of business mix and underwriting risk. One of the key factors to improve diversification in insurance companies is the geographical spread of underwriting risks. Premium volume or market share alone does not represent diversification for business purposes. For Non-Life insurance, P&C and credit-trade insurance, the geographic location of the business can have a material impact on its financial profile if unexpected catastrophic events take place, such as natural disasters, terrorist attacks, sovereign crises, etc..

The assessment of geographic concentration is determined following the definitions described as follows:

Geographic Concentration Assessment – Definitions
Excellent: Excellent geographic diversification, with large presence in major global regions and a balanced combination of developed and non-developed countries that add diversification benefit. Strong: Strong geographic diversification, with presence in major global regions/countries and a combination of countries that add diversification benefit. Neutral: Satisfactory geographic diversification, with presence in one major global region/country and a satisfactory combination of countries/regions that reduces volatility. Weak: Weak geographic diversification, with presence in one region/country and a weak combination of countries/regions with evidence of large volatility. Very weak: Very weak geographic diversification, with presence in one region/country and a very weak combination of countries/regions with evidence of very large volatility.

6. Product Quality and Product Development

a. Product Quality

The product quality provided by an insurance company gives an indication of the level of acceptance and retention rates of customers. The quality of products is sometimes not entirely known and it is mostly evidenced by negative customer experiences and negative brand sentiment. Therefore, the real risks for the insurance company include not delivering quality products, customers not renewing and also failing to attract new customers. These can have material effects on the operating profitability, firstly with lower than expected premiums underwritten, and ultimately loss of market share.

The product quality assessment is determined following the definitions described as follows:

Product Quality Assessment – Definitions
Excellent: Excellent product quality, customer service with excellent feedback and excellent brand recognition. Strong: Strong product quality, customer service with very positive feedback and positive brand recognition. Neutral: Satisfactory product quality, customer service with positive feedback and satisfactory brand recognition. Weak: Weak product quality, customer service with negative feedback and weak brand recognition. Very weak: Very weak product quality, customer service with negative feedback and very weak brand recognition.

b. Product Development and Innovation

Innovation is becoming increasingly critical to the long-term success of insurers. With innovation, companies can develop sustainable competitive advantages and better respond to external challenges such as evolving consumer preferences, growing business, technological changes and consumers' needs.

The assessment of product development and innovation is determined following the definitions described as follows:

Product Development and Innovation Assessment – Definitions
Excellent: Excellent product development, with innovation and services ahead of competitors, leader in the market in terms of innovation and IT platforms. Strong: Strong product development, with innovation and services ahead of competitors, among the leaders in the market in terms of innovation and IT platforms. Neutral: Satisfactory product development, with innovation and services similar to competitors, follows the market trends in terms of innovation and IT platforms. Weak: Weak product development, with innovation and services behind competitors, lack of innovation and IT platforms with limited customer interaction. Very weak: Very weak product development, with innovation and services behind competitors, lack of innovation and IT platforms with very limited customer interaction.

III CORPORATE GOVERNANCE & RISK MANAGEMENT

1. Governance

The assessment of an insurance company's corporate governance framework is an important factor in determining the quality of management, the fulfilment and predictability of the strategic plan and long-term performance. It therefore affects the long-term financial stability and sustainability of any insurance company. Since the approach to corporate governance can be very different depending on the ownership structure of a company, the qualitative judgment made by ARC takes into account the complexity of the ownership structure.

A review of the company's vision, mission, definition, procedures, internal policies and business practices is crucial to understand and identify potential risks from lack of governance or management weaknesses. Our assessment includes an opinion on how the insurance company manages its relationships with all stakeholders including shareholders, financial markets, regulatory authorities, employees, policyholders and any other relevant parties.

ARC's assessment of corporate governance is determined by a notching adjustment that can be 'Neutral', '-1' or '-2'. The rationale behind this is based on the fact that corporate

governance should be a minimum standard of best practices in every company. ARC gives no credit to strong corporate governance, since it should represent a standard level of professionalism and management responsibility. However, there is a negative stance applied to those frameworks that in ARC's opinion do not comply with minimum industry standards or best practices and therefore, represent a flaw that could lead to potential governance risks. A comprehensive list of questions and topics that are usually discussed when evaluating corporate governance include:

- Composition of the board of directors/supervisory board, background and independency.
- Concentration of power of decision-making processes.
- Are strategy and objectives communicated within the organisation and how aligned are they within the organisational structure?
- Is the ownership structure a limitation to adequate corporate governance?
- Is risk tolerance appetite clearly determined and communicated?
- How is the risk management function structured and managed?
- How experienced is the senior management?
- Are internal procedures and practices clearly defined, communicated and applied?
- What has been the outcome of the last inspection made by the regulator?
- Is there any evidence of complexity of the ownership structure?
- Structure of the management compensation packages. Are the incentives for management compensation aligned with a sustainable long-term perspective of the institution?
- Is there any evidence of moral hazard risk?
- Is there any evidence of key man risks?
- Quality of reporting, controls and monitoring of the board to management level.
- Evidence of any legal or regulatory dispute that can affect the reputation of the entity.
- Any compliance breach, exception, or fine from a regulatory institution.
- Other relevant aspects.

As part of the governance assessment, ARC also highlights the importance of financial reporting in terms of quality, transparency and timing. The disclosure of financial information of poor quality that lacks transparency, or is published late, is considered weak corporate governance by ARC.

The notching adjustment applied under the governance assessment is detailed as follows:

Governance Assessment – Definitions
Neutral: Satisfactory governance, management follows best practices, no evidence of potential governance issues. -1 notch: Weak governance, some risks can arise and put pressure on the governance structure. -2 notches: Very weak governance, evidence of material risks arising from the current governance structure.

2. Risk Management

For ARC, insurance companies with a proven ability and expertise to successfully manage underwriting and investment risks are likely to maintain their long-term financial sustainability. An insurance company's ability to generate operating profits under a solid risk management framework in terms of underwriting policies, investment strategy and product risk management is analysed and challenged, based on the operational environment and diversification strategy. The business model developed by insurance companies that carry underwriting, product and investment risks needs to be managed well to provide long-term profitability. This profitability is in turn, the result of an appropriate pricing structure that identifies and fairly estimates the underwriting risks acquired. Since the overall profitability that insurance companies achieve is highly determined by the level of risks accepted and rejected, the management of reserving risk, reinsurance, investment, liquidity, capital management, concentration and operational risks should be economically profitable in the long-term.

Companies operate in dynamic environments and need to identify and address potential risks on an ongoing basis. Accordingly, the company's risk management policy is a key consideration in ARC's rating analysis. Insurers that develop a formal framework to quantify and manage risk within accepted risk tolerance levels are better equipped to manage potential volatility in earnings and capital. This requires an entrenched risk management awareness that extends to all aspects of the business. While ARC accepts that the extent of sophistication differs depending on markets and industry requirements, the emphasis that a company places on risk management is an important consideration in the rating decision. The analysis of risk management includes specific analysis of the following factors:

- Reserving risk.
- Reinsurance risk.
- Investment risk.
- Liquidity risk.
- Capital management risk.

- Operational risk.

The notching adjustment applied under the risk management assessment is detailed as follows:

Risk Management Assessment – Definitions
+2 notches: Excellent risk management framework, all risk factors managed following best practices and with no evidence of issues that can trigger unexpected losses. +1 notch: Strong risk management framework, all risk factors managed following best practices and no evidence of issues that can trigger unexpected losses. Neutral: Satisfactory risk management framework, most risk factors are managed following best practices, limited evidence of potential issues that can trigger unexpected losses. -1 notch: Weak risk management framework, some risk factors are managed following short-term incentives, evidence of issues that can trigger unexpected losses. -2 notches: Very weak risk management framework, most risk factors are managed following short-term incentives, evidence of material issues that can trigger unexpected losses.

IV OTHER ADJUSTMENTS

1. Country Risk and Industry Dynamics

a. Country Risk

The importance of country risk and macroeconomic conditions is highly correlated to the performance of the insurance industry. Due to the nature of the industry, the state of the local economy has direct effects on the demand for insurance services and thus impacts the ability of market players to generate earnings. Since insurance products are very diverse in origin, the demand for more specific and sophisticated products is highly dependent on the country's development stage and the penetration level of insurance products within its population. For example, it is known that in more mature markets, the offer of very specific and more specialised insurance products is larger, e.g. specific health insurance, income insurance, earthquake insurance, etc.. On the other hand, economies highly exposed to natural disasters (e.g. floods, earthquakes, hurricanes etc.) are very specific and regulated in terms of the minimum insurance coverage required to cover those risks. In those cases, the analysis of the local and macro economy and the level and development of supply and demand of insurance products is analysed. Hence, the analysis and assessment of a country's economic growth trend is a key driver to understand its demand for insurance services and further, to assess an insurance company's expected performance.

Companies domiciled, conducting business, and/or with asset exposure in higher-risk countries are subject to more volatile external conditions, as business cycles are amplified. In these countries, a strong initial capital position can erode more quickly; However, ARC does not place a cap based on a sovereign credit rating of the country in which the insurance company is domiciled or to which it is materially exposed. If feasible, for insurance companies that develop global business models, the local and macro economy analysis is done through a weighted average of the most relevant countries in which the company conducts its businesses.

The notching adjustment applied under the country risk assessment is detailed as follows:

Country Risk Assessment – Definitions
+2 notches: Excellent and sustainable growth, excellent fiscal equilibrium and no evidence of political instability. +1 notch: Strong and sustainable growth, strong fiscal equilibrium and limited evidence of political instability. Neutral: Satisfactory and stable growth, satisfactory fiscal equilibrium, political changes occur that do not affect significantly the operational environment for companies. -1 notch: Weak and unstable growth, weak fiscal equilibrium, political changes affect the operational environment for companies. -2 notches: Very weak and negative or zero growth, very weak fiscal condition with high level of government debt, political changes that affect significantly the operational environment for businesses.

b. Industry Dynamics

ARC focuses its industry dynamics analysis, amongst others, on the following drivers:

- Growth potential of insurance products.
- Supply and demand equilibrium of insurance products.
- Barriers to entry and exit for insurance companies.
- Penetration of insurance products into the population.

The notching adjustment applied under the industry dynamics assessment is detailed as follows:

Industry Dynamics Assessment – Definitions
+2 notches: Excellent growth potential for insurance products, excellent equilibrium for demand and supply of insurance products, low barriers to entry for insurance companies, excellent penetration and density of insurance products into the population and markets. +1 notch: Strong growth potential for insurance products, strong equilibrium for demand and supply of insurance products, relatively low barriers to entry for insurance companies, strong penetration and density of insurance products into the population and markets. Neutral: Satisfactory growth potential for insurance products, satisfactory equilibrium for demand and supply of insurance products, some barriers to entry for insurance companies exist, satisfactory penetration and density of insurance products into the population and markets. -1 notch: Weak growth potential for insurance products, weak equilibrium for demand and supply of insurance products, high barriers to entry for insurance companies, weak penetration and density of insurance products into the population and markets. -2 notches: Very weak growth potential for insurance products, very weak equilibrium for demand and supply of insurance products, very high barriers to entry for insurance companies, very weak penetration and density of insurance products into the population and markets.

2. Regulatory Risk

The regulatory environment provides the base in which an insurance company develops and sets its business practices. A sound and transparent regulatory environment, with a framework set by a fully independent and credible regulator that shows evidence of empowerment and has control over companies with best practices, promotes a healthy industry environment with adequate incentives.

The regulatory environment can be characterised by frameworks that implement multilateral agreements (e.g. Solvency II requirements) or by more local regulators that customise regulatory frameworks based on country specific requirements (mainly concerning capital adequacy levels, minimum reserve requirements or specific reporting standards). For ARC, it is expected that the main objective of the regulator is to promote a healthy insurance industry framework. Following on from this, ARC expects that the regulatory framework and therefore the potential for regulatory risk is limited and should be aligned with the best interests of market participants. Advances in terms of promoting best practices and anticipating upcoming regulations from different regulatory authorities is highly valued and assessed accordingly.

It is worth noting that regulatory homogeneity in the insurance industry in terms of reporting is also addressed and analysed. The different levels of information disclosure

required by country-specific regulators represents a challenge for comparison purposes and therefore needs to be addressed carefully.

For insurance companies that have operations in more than one country with a relevant size (primarily in terms of gross premiums, net premiums written or, depending on disclosure, earnings contribution or assets), the analysis includes an assessment of the secondary country's regulatory framework as well.

The notching adjustment applied under the regulatory risk assessment is detailed as follows:

Regulatory Risk Assessment – Definitions
+2 notches: Applies only to entities regulated at a global level (Globally Systemically Important Insurers - GSII). Fully developed and highly transparent regulatory framework with long track-record of consistent, predictable and independent decisions. Regulation is standardised with no exceptions in its application. +1 notch: Well-developed framework with above average transparency, reliability and predictability; track- record of consistent, predictable and independent decisions. Some exceptions in the application of the regulatory framework are applied, mostly following the framework applied by national authorities in the best interest of the characteristics of the domestic market to migrate to a standardised approach in the medium term. Neutral: Regulatory framework that is moving to a consistent application of industry best practices, with average level of transparency, reliability and predictability. Track-record of consistent and independent decisions. Exceptions in the application of the regulatory framework are in place applied by national authorities in the interest of the characteristics of the domestic market. -1 notch: Regulatory framework that applies a flexible approach towards industry best practices with a high degree of inconsistency or significant lack of transparency. Exceptions to the application of the regulatory framework are easy to be identified. -2 notches: Undefined or unclear regulatory framework with strong political interference and track-record of inconsistent and hostile decisions.

3. Social and Environmental Risk

ARC incorporates Environmental, Social and Governance (ESG) factors into its ratings mostly through qualitative analysis. Since the Governance aspect is covered in a previous specialised section in our Criteria, this section only includes the factors related to Environment and Social risks.

Environmental factors to be considered in the analysis include:

- Climate related risks:
  - Physical Risks related to arising climate trends

  - Transition risks related to the transition to a low carbon economy.

  ARC would expect alignment with the best practices published through the Financial Stability Board Task Force on Climate-related Financial Disclosures (TCFD)

- Biodiversity loss.
- Air pollution.
- Water management and pollution.
- Resources depletion.
- Energy management.

Exposure to climate change and losses from natural catastrophes are, by far, the most relevant factors, in particular for property and casualty insurers and reinsurers.

We assess both the consequences (existing or potential) from the environmental factors, as well as the impact of regulatory or policy initiatives aimed at minimising or preventing the deterioration of these environmental factors.

Social factors that could be included into the analysis are:

- Consumer protection, including privacy and data security.
- Labour relations and practices.
- Integration in the community and affordability.
- Stakeholders opposition.

ESG factors typically may differentiate ratings between different sectors, but generally will only differentiate ratings from issuers within the same sector when an issuer is unusually strong or weak in a specific ESG factor.

Where ESG factors are a key driver behind the assignment or change of a credit rating or rating outlook this will be outlined, the ESG factor that was considered a key driver identified and its materiality will be explained in the accompanying press release or report.

For ARC, ESG factors are not based on quantitative data nor have a specific score; the impact of the analysis is applied using notching adjustments if, from the analysis, it is determined that a potential risk for the issuer is identified that can affect the rating in the long term.

4. Group Support

Support could come from an identified support provider. The support providers considered by ARC in the case of insurance companies are: (a) Parent / Holding Company / Group, and (b) Government.

After the identification of the support provider, ARC assesses the potential support that will be translated into notching adjustments. For each support provider, we review a list of conditions that could add or reduce the potential of support from the identified support provider.

It is worth noting that group support would be typically a neutral or positive factor to the IFSR. However, in specific cases in which ARC analysts consider that because of particularities of the group structure, or due to conditions that limit the financial independency of the insurance company, support could negatively affect the IFSR. These cases, although rare, will be disclosed accordingly.

a. Parent / Holding Company / Group

'Parent Company' or 'Holding Company' is the company that has the ultimate power for management, coordination and control of companies, subsidiaries and affiliates.

'Group' is the Parent Company/Holding Company and the companies controlled by or with participation from or affiliated to the Parent Company/Holding Company. Groups may operate across different geographical jurisdictions, with complex control and ownership structures. Consequently, we use analytical judgment to define the scope of a group and, therefore, the extent of the group identified for analytical purposes could differ from the official and/or legal group structure.

To evaluate the level of support expected to be received by a subsidiary or affiliate, for the cases where the company is part of a Group, with a Parent Company or Holding Company (as defined above), ARC evaluates various factors, primarily the following:

Existence of any form of guarantee or legal obligation to support the subsidiary by the Parent Company/Holding Company. In that case, due to the obligation to provide support, the notching up of the company's IFSR could be increased up to the level of the Parent Company/Holding Company. Even though the Parent Company may not have any formal or explicit commitment to support the operations of a subsidiary, ARC evaluates the strategic importance of the subsidiary and its effects on the Parent's reputation and market confidence if a potential default affects its operation. In that context, we use the concept of 'strategic importance' and consider giving uplift to the subsidiary's IFSR based on the financial strength of the Parent Company/Holding Company/Group. Although ARC evaluates the eventual support from the Parent Company/Holding Company/Group, the track record and previous examples of support highlighted during past crisis is considered a key element.

ARC also evaluates the structure and organisation of a Group, the legal ownership, organisational structures, direct and indirect control mechanisms and intragroup relationships to assess the financial strength of the Group to evaluate the potential for external support when there is no explicit guarantee or legal obligation to provide support from an existing Parent/Holding Company/Group.

The factors assessed to identify potential notching for Parent Company/Holding Company/Group support are as follows:

- Support or bailout history.
- High ultimate Parent Company/Holding Company/Group financial strength.
- Direct ownership structure.
- Guarantees (implicit / explicit).
- Strategic importance (brand sharing, profits, assets, region).
- Operational integration.
- Reputational risk.
- Operational environment differences.

b. Government

Support from government to insurance companies has been historically proven in isolated cases. However, ARC includes the analysis of eventual support from government in case the entity is owned (in part or fully) by the government or viewed as systemically important. When the stability of the domestic financial system is at risk, governments would be willing to support insurance companies if needed. However, a government may be more willing to support those companies in which it has direct investment, through mechanisms such as direct cash and capital injections, liquidity facilities, long-term debt, subordinated debt provisions, guaranteed debt programmes etc..

For systemically important insurance companies, the incentive for the government to provide support is driven by the catastrophic consequences of a company facing a scenario of insolvency, with a direct effect on investors' confidence, possible contagion to the financial system and the real economy. In those cases, the support to systemically important insurance companies comes from a desire to avoid any further damage to capital markets and thereby support macroeconomic and social stability. It is worth mentioning that in those cases where ARC considers the government does not have a sound financial profile or enough financial resources to provide support, the level of support expected is adjusted accordingly.

In that context, ARC identifies those insurance companies that, in extreme scenarios are likely to receive Government support in case of financial distress. The factors analysed to assess potential notching from Government support are as follows:

Insurance industry importance (assets or premiums written to total GDP).

- Bailout history.
- Legal capacity.

- Public sentiment.
- Insurance industry regulatory/legal framework, development.
- Geographic diversification.
- Business activity (traditional, monopoly position, important niche player, important capital market position).

Support due to:

- Capital shortfall from regulatory requirements.
- Fraud or similar.
- Extra-national problems.
- Issues from non-core operations.
- State guarantee.
- State ownership.

VI. OTHER RATINGS

DEBT OBLIGATIONS (SENIOR AND SUBORDINATED)

ARC also assigns ratings to debt issued by an insurer or insurance holding. In assigning ratings of debt obligations we consider the organisational structure of the company or group, the BR, IFSR and ICR. The ratings of debt obligations are notched from the ICR. The notching applied depends on the different features of the debt instrument (including senior and subordinated debt, secured and unsecured, or issued by an operating company or holding).

A. Senior Debt Obligations:

Ratings assigned to senior debt are either equal to or notched from (above or below) the ICR depending on the level of expected recoveries (for example, recoveries could come from guarantees, credit enhancement and/or other sources). In jurisdictions where policyholder claims rank above senior and subordinated debt, we would usually deduct one notch. However, in certain cases a debt rating is not notched down when the ICR is high and the issuer's financial characteristics are very strong. We also will take into consideration any additional collateralisation or guarantees to senior debt obligations. In cases of speculative grade (BB+ and below) issuers, with weak financial characteristics, the notching down could be wider. For insurance companies where asset encumbrance elevates the credit risk of subordinated or senior unsecured debt, we apply further notching down.

B. Subordinated Debt Obligations:

Ratings assigned to subordinated debt obligations are also notched down from the ICR. We believe that given the on-going promotion of the overall burden sharing in case of distress by policy makers and regulators, subordinated debt instruments should be evaluated carefully on an individual basis. However, our general approach is to incorporate a 'two notches' haircut from the ICR.

The notching differential for subordinated debt obligations is based on a more specific assessment of the characteristics of the debt instrument, according to the following items:

- Subordination level in the capital structure.
- Coupon skip and loss absorption mechanisms.
- Interest coverage and leverage.
- Additional revenue sources and other financial strengths (or weaknesses) for holding entities.

The generic indication on insurance operating entity's debt ratings (final notching could differ depending on individual characteristics of the company/group and the debt issuance) is as follows:

- Senior debt rating = Operating entity's ICR minus one notch.
- Subordinate debt rating = Operating entity's ICR minus two notches.
- Preferred shares rating = Operating entity's ICR minus three notches.

The debt ratings issued by insurance operating holding entities typically have different notching to reflect the relative priority ranking and different recovery expectations. The generic indication on insurance operating holding entity's debt ratings (final notching could differ depending on individual characteristics of the company/group and the debt issuance) is as follows:

- Senior unsecured debt rating = Operating holding's ICR.
- Subordinate debt rating = Operating holding's ICR minus one notch.
- Preferred shares rating = Operating holding's ICR minus two notches.

In assessing the debt rating of the operating holding entity, we also consider additional factors including:

- The rating level of the operating entity and holding, if in speculative grade (BB+ and below) the notching difference could be wider indicating increasing credit risk.
- Management structure of the group, regulatory and legal aspects.
- Diversity and historic track record of income sources.
- Stand-alone holding company's investment portfolio, liquidity and additional liquidity sources relative to capital, debt servicing costs.
- Consolidated financial leverage and double leverage.

As an example:

Entities & Instruments	General Approach for Investment Grade Rated Entities	General Approach for Speculative Grade Rated Entities
Main operating entity of the group		
ICR	**A**	**BB+**
Senior unsecured debt	A-	BB
Subordinated debt	BBB+	BB-/B+
Preferred stock & junior subordinated debt	BBB	B+/B
Holding entity		
ICR	BBB+	BB-/B+
Senior unsecured debt	BBB+	BB-/B+
Subordinated debt	BBB	B+/B-
Preferred stock & junior subordinated debt	BBB-	B-/CCC

HYBRID SECURITIES

To evaluate the scope of debt or equity like characteristics of any hybrid issuance, we focus on the maturity, cumulative versus non-cumulative character of coupon suspension, structural ranking of the hybrid security, various capital features and triggers. We assess and recognise the proportion of equity versus debt content in an issuer's capital structure on a case-by-case basis, depending on the structure of the specific security.

In general, a high equity proportion is recognised on deeply subordinated hybrid securities that usually are represented in the most junior instrument in the issuer's capital structure. These are characterised by strongly protective and non-cumulative coupon suspension conditions, 'can't default' or cross default, with long maturity or payment at perpetuity. Hybrid securities with weak loss absorption features, higher priority of claim in liquidation or short maturity (generally less than 20 years) would be treated as debt-like instruments with low or no equity proportion. Nevertheless, we assess the regulatory rules and requirements for hybrid eligibility.

Usually, hybrid securities do not represent a significant proportion of overall debt and their treatment has marginal impact on an issuer's capital structure and rating. However, we consider hybrid equity as a weaker form of capital. It could also be limited to a threshold for the calculation of equity content in cases where other forms of capital, different from shareholders' equity, represents a high proportion of overall capital. Therefore, credit ratings for any hybrid security are assessed on a case-by-case basis and in general, notched down from the ICR. Securities with high equity proportion tend to be subject to higher notching difference, compared to debt-like cases.

SHORT-TERM DEBT RATINGS

Commercial Paper debt or programmes are defined as an unsecured, short-term debt instrument. We use the short-term rating scale to assign ratings to Commercial Paper debt or programmes. In general, these ratings are assigned based on an indicative mapping between short-term and long-term credit ratings. In cases in which the insurance company presents evidence of a stronger/weaker liquidity profile determined by the liquidity analysis, the rating could differ from the indicative mapping.

VII. RATING MODIFIERS

An Indicative Rating - evidenced by the suffix (ind) – is a rating assigned by ARC to an issuer or an instrument (most commonly structured or project finance debt issues) when the assignment of a final rating is dependent upon the fulfilment of specific contingencies. Any material deviation in the fulfilment of these contingencies from the assumptions underlying the Indicative Rating can have a material impact on the final rating accorded, which accordingly may be fundamentally different to the initial Indicative Rating. Moreover, ARC reserves the right not to issue a final rating. Potential investors are advised to bear this in mind when considering any indicative rating.

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